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E.O. 12958: N/A
TAGS: ECON EFIN EINV PGOV CH
SUBJECT: Credit Tightening Squeezing Small and Medium Enterprises in the Pearl River Delta

REF: A) Guangzhou 214, B) Guangzhou 228, C) Guangzhou 291

¶1. (SBU) Summary: Monetary tightening measures taken by the China Banking Regulatory Commission (CBRC) have greatly reduced the amount of credit available in south China, according to bank executives and industry watchers. Small and medium enterprises (SMEs) are having difficulty obtaining credit, causing many businesses to borrow from unlicensed lenders. While the central government has increased efforts to ensure that SMEs in favored industries have access to credit, observers question the effectiveness of these measures. Concern is growing about the potential for increasing non-performing loans (NPLs) and greater chances of labor unrest as the business climate worsens for SMEs in south China -- which could create significant social and economic unrest with which the local leadership would have to deal. End Summary.

Credit Tightening Affecting SMEs

¶2. (SBU) In recent conversations with bank executives, academics, and financial journalists, Congenoffs noted wide agreement that the CBRC's monetary tightening policies have resulted in a large reduction of bank lending in south China. The Xinhua News Service website published an article from the official Shanghai Securities News ("Shanghai Zhengquan Bao") reporting that lending by Guangdong banks declined 15% year-on-year in the first quarter of 2008. Brendan Wong, General Manager of Bank of Montreal's Guangzhou Branch, told us his bank has received numerous inquiries from companies that were denied by larger banks that had already reached their CBRC-enforced loan quotas. Wong described this new business as so brisk that his bank also quickly hit its own lending quota and was forced to start turning away applications that it previously would have approved.

¶3. (SBU) The reduction in lending has left some companies unable to secure credit from legitimate sources. Shenzhen Development Bank Chairman and CEO Frank Newman told Consul General Goldberg, "It's clear now that the supply of legitimate lending does not meet the demand." Dr. Lu Jun, Director of Sun Yat-sen University's Banking Research Center, told us that young SMEs are the group most affected by China's credit contraction, as banks currently favor companies with established cash flows and real estate holdings that can be used as collateral. Dr. Lu asserted that even SMEs with 10-year credit histories are having trouble securing loans, with no help coming from capital markets as the much-anticipated launch of Shenzhen Stock Exchange's new "SME Board" continues being delayed (ref A). Similarly, an unnamed Guangdong government official was

quoted in the Shanghai Securities News as saying that banks in the province are currently able to satisfy just 40% of SME credit demands.

¶4. (SBU) Dr. Lu commented that this tightened liquidity has led banks to seek creative ways of circumventing government-imposed loan quotas. Some banks, he said, are providing credit guarantees rather than loans, since the former are off-balance sheet and do not have to be reported to regulators unless they go bad. With bank lending growing scarcer, many companies are making greater use of commercial credit. Still, Andy Zhang, Bank of America's Guangzhou Branch Manager, told us that such alternative sources of credit are also becoming more difficult to obtain, as the tightening has begun to reduce the credit available for even the strongest firms who might be willing to help cover their weaker business partners.

Turning to Unlicensed Lenders for Credit

¶5. (U) Companies unable to secure bank or commercial credit are increasingly turning to unlicensed lenders. Short-term financing is readily available from pawn shops, while longer-term loans can often be obtained from informal networks of friends or underground banks. According to Shanghai Securities News, a surge in demand for short-term credit recently caused the interest rate for one-month term loans at Guangzhou pawn shops to spike from an historic average of 3% to as high as 6% (Note: the higher rate is equivalent to an annual interest rate of 72%. End note.) The same article reported that similar loans in Foshan City of Guangdong had risen from monthly interest rates of 5-6% to as high as 10%. Although relatively little information is available about underground banks,

the Chinese government announced last fall that it shut down a Shenzhen-based operation that had conducted transactions in all 32 provinces and made loans totaling 4.3 billion RMB (624 million USD) over an 18-month period.

Government Efforts to Help SMEs

¶6. (SBU) Aware that SMEs are the companies most affected by restricted bank lending, the Chinese government has tried to help cushion the blow -- at least for those SMEs in favored industries. Bank of Montreal's Wong told us the People's Bank of China has repeatedly requested that his bank expand its SME lending, even though their business plan only includes lending to large international companies. In March, the CBRC issued a circular (number 71) requesting that banks maintain SME lending growth rates at least as high as each bank's overall lending growth rate. In addition, municipal governments in Guangdong are using their jointly owned guarantee companies to help secure credit for SMEs in government-endorsed industries. Sun Wanqing, CEO of Guangdong Yinda Guarantee, the province's largest guarantee company, told us his company mostly supports SMEs that are investing in higher-value production industries favored by the government.

Bankers Doubt Government Solutions

¶7. (SBU) Several international bank executives with whom we spoke expressed skepticism that government measures to promote SME lending would make much difference for the companies. Peter Qiu, Guangzhou Branch Manager for Citibank, told us the liquidity contraction will primarily affect smaller companies that lack government connections. He said Guangdong's economy is likely to experience "unhealthy growth" in the next couple years as inefficient state-owned enterprises with strong government ties receive preferential treatment when applying for scarce bank loans, a big difference from what will happen to smaller, private companies. Bank of America's Zhang told us SMEs simply aren't a high priority for the Chinese government, which is more worried about inflation and the health of top-tier companies. There are also indications that guarantee companies are losing their ability to encourage policy-inspired lending: Shanghai Securities News reported that the lending value of Guangdong's guarantee firms declined by 30% in the first quarter of

2008, and some banks had gone as far as suspending their partnerships with guarantee companies.

Growing Problems

¶8. (SBU) Little doubt remains that south China's lending contraction is coming at a particularly bad time for SMEs. Thousands of Hong Kong and Taiwan-owned factories in the Pearl River Delta (PRD) have closed in the last few months, due to rising costs (ref B). Many of these factories were closed illegally, as owners have sought to avoid paying the obligations incurred by closing legitimately (ref C). Peter Pak-yan Leung, the Director of Hong Kong's Economic and Trade Office (ETO) in Guangzhou, told us that he expects thousands more factories to close in the months after the Olympics, and that in most cases, he expects these factory managers to simply leave town in the middle of the night without paying their workers.

¶9. (SBU) Surging SME failures could also lead to a rebound in the number of NPLs held by Chinese banks. Most bank executives with whom we met indicated that they expect NPLs to emerge as a growing problem for banks that aggressively lent to south China's SMEs. Bank of America's Zhang said several of his counterparts at China's Big Four banks have told him they are "very concerned" about NPLs in this segment. Citibank's Qiu was somewhat sanguine: while he expects NPLs to become a more serious problem, he thinks most of the nation-wide commercial banks will avoid trouble. Qiu argued that few of these banks -- except Shenzhen Development Bank and a couple other leading SME lenders -- have significant exposure to SMEs, so he predicted that NPL problems will largely be confined to municipal commercial banks.

Comment

¶10. (SBU) It is clear that the PRD economy is in transition, with

many low-margin and small-scale exporters struggling due to a difficult economic environment and greatly reduced availability of credit. Tightening monetary conditions primarily through quantitative credit controls rather than by raising the cost of credit through higher interest rates is disproportionately impacting south China's SMEs. The question is whether the current economic weaknesses will be confined to certain industries, as Bank of America's Zhang asserted, or if inefficient capital allocation or other market forces could cause economic distress to extend into other areas of the economy, as Citibank's Qiu suggested. If, as Hong Kong ETO's Leung predicts, thousands of Hong Kong businessmen will sneak out of town by the end of the year, leaving behind empty factories and tens or hundreds of thousands of unemployed and unpaid migrant workers, Guangdong's leadership could be dealing with a significant and destabilizing economic and social condition.

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